Before the
Administrative Hearing Commission
State of Missouri

EXPRESS SCRIPTS, INC. AND SUBSIDIARIES,	)	
Petitioners,	)	
vs.	)	No. 13-0865 RI
DIRECTOR OF REVENUE,	)	
Respondent.	)	

DECISION

We deny the motion for summary decision filed by Express Scripts, Inc. and Subsidiaries (collectively, "ESI"), and grant the motion for summary decision of the Director of Revenue ("the Director"). ESI is liable for $1,028,206 in corporate income tax for 2006, plus statutory interest.

Procedure

On May 17, 2013, ESI filed its complaint, appealing the Director's final decision denying ESI's protest of the Director's assessment for Missouri corporation income tax period 2006. Previously, ESI had filed an appeal of the Director's final decision concerning ESI's 2007 income taxes, to which we assigned case number 10-2337 RI. On July 23, 2013, ESI filed a motion to consolidate #10-2337 RI with this case. On July 29, 2013, we granted the motion.[1]

[1] While we have consolidated the two cases, we nonetheless issue a decision here for 13-0865 RI only. Also, because of the consolidation, certain exhibits and affidavits filed in 10-2337 RI are discussed here.

On November 1, 2013, ESI filed a motion for summary decision, proposed findings of fact, proposed conclusions of law, and brief. Also on November 1, 2013, ESI and the Director filed a joint stipulation of facts. On December 4, 2013, the Director filed a response to ESI's motion for summary decision and a cross-motion for summary decision. On January 7, 2014, ESI filed a reply brief in support of its motion for summary decision and a response to the Director's cross-motion for summary decision.

Findings of Fact

1. ESI was, at all relevant times, an "affiliated group" of corporations within the meaning of I.R.C. § 1504(a).

2. Prior to 2001, ESI had filed consolidated Missouri and federal corporate income tax returns.

3. Starting in taxable year 2001 and at all subsequent, relevant times, ESI filed consolidated federal income tax returns.

4. On April 23, 2002, ESI received permission from the Director for its members to file separate Missouri income tax returns.

5. Members of ESI's affiliated group with a Missouri nexus filed separate Missouri income tax returns for 2001-2003.

6. On October 14, 2005, ESI requested permission from the Director to file a consolidated Missouri income tax return for 2004.

7. On October 28, 2005, the Director denied ESI's request to file a consolidated Missouri income tax return for 2004.

8. On October 17, 2005, ESI filed a consolidated Missouri income tax return for 2004, and on October 16, 2006, ESI filed a consolidated income tax return for 2005.

9. The Director rejected those consolidated returns.

10. ESI's members having Missouri taxable income then filed separate Missouri income tax returns for 2004 and 2005.

11. ESI filed a consolidated federal income tax return for 2006 on September 15, 2007.

12. ESI filed a consolidated Missouri income tax return for 2006 on October 15, 2007.

How ESI calculated and applied its net operating losses

13. On line 30 of its 2006 consolidated federal income tax return, ESI reported taxable income of $481,326,467.

14. On line 1 of its 2006 consolidated Missouri income tax return, ESI reported federal taxable income of $18,606,843.

15. The difference between the figures for taxable income on ESI's 2006 federal return and its 2006 Missouri return, $462,719,624, constituted the amount of net operating loss ("NOL") ESI was claiming as a deduction. The amount of that NOL deduction would later change according to circumstances, including those described below.

16. As a result of an IRS audit for 2003 and 2004, $54,734,719 was added to ESI's consolidated NOLs for 2003, and $30,936,065 was added to ESI's NOLs for 2004.

17. As a result of the additional NOLs for 2003 and 2004, the amount of separate company NOLs ESI claimed as a deduction was increased to $548,390,407.

18. Upon review by the Director, he discovered that, of the $548,390,407 set out above, $5,088,077 had been carried back to the 2001 and 2002 separate company Missouri income tax returns of Express Scripts Sales Development Company.

19. As a result of another IRS audit for tax years 2005-07, $3,456,151 was added to ESI's federal income tax liability for 2005, and $1,032,812 was subtracted from ESI's federal income tax liability for 2006.

20. As a result of the IRS audit for 2005-07, the available separate company NOLs available to ESI to offset Missouri taxable income was reduced by $230,952. When that amount, as well as the $5,088,077 already claimed as an NOL in 2001 and 2002 by Express Scripts Sales Development Company, were subtracted from the original amount of available separate company NOLs ($548,390,407), the resulting amount available to ESI to reduce Missouri taxable income was $543,071,378.

21. The available NOLs generated by ESI's subsidiary corporations that filed Missouri income tax returns for 2001-05 totaled $408,373,826.

Examination of 2006 return by the Director, protest, and final decision

22. The Director examined ESI's 2006 Missouri corporate income tax return and issued a notice of adjustment on September 30, 2010.

23. The above-referenced notice of adjustment adjusted ESI's federal taxable income from $18,606,843 to $481,640,354.

24. On October 5, 2010, the Director issued a notice of deficiency, calculating a total balance due of $1,309,105.45, including unpaid tax, interest, and penalty for 2006.

25. On November 11, 2010, ESI protested the 2006 notice of deficiency, asserting its right to deduct NOLs of its members who had incurred those losses in years when they had filed separate Missouri returns.

26. On April 24, 2013, the Director issued a final decision denying ESI's claim to deduct the NOLs of its members who had incurred those losses in years when they had filed separate Missouri returns. Based on that decision, the Director decided that ESI's 2006 Missouri income tax liability was $1,034,496 and, after applying credits of $162,458, it had an

underpayment of $872,038. With interest computed to May 30, 2013, the total due was $1,123,948.61.[2]

27. The parties have stipulated (and we find as fact) that the entries on the following chart set out what ESI's 2006 Missouri income tax calculation and obligation would be under three scenarios: it is entitled to use the NOLs from all its subsidiaries; it is entitled to use the NOLs only from those subsidiaries with a Missouri nexus; and it is not entitled to use any of those subsidiaries' NOLs.

	Entry in Federal or Missouri return, or figure generated by other means	**2006- all NOLs available**	**2006- only NOLs from members with Missouri nexus**	**2006- no NOLs available**
A	Federal taxable income, federal Line 30 (as originally filed)	481,326,467	481,326,467	481,326,467
B	Federal RAR adjustment[3]	(2,950,892)	(2,950,892)	(2,950,892)
C	Federal taxable income, Federal Line 30 (as amended)[4]	478,375,575	478,375,575	478,375,575
D	Separate company net operating loss[5]	478,375,575	408,373,826	0
E	Federal taxable income, Missouri line 1[6]	0	70,001,749	478,375,575
F	Missouri additions, subtractions, and Federal income tax deduction[7]	(75,721,446)	(75,721,446)	(75,721,446)

[2] Exhibit A to ESI's complaint in this case. The parties stipulated that ESI's 2006 tax owed would be $1,028,026 if, as we conclude here, it is not allowed to deduct any of the prior-year, separate company NOLs it claims. Joint stipulation ¶ 7.

[3] "RAR" stands for "Revenue agent's report." It is a report indicating any adjustments made to a tax return as a result of an IRS audit. *Black's Law Dictionary* (9th ed.) 1433.

[4] A minus B.

[5] Item C minus either the entire amount of NOLs generated by ESI's members during the loss period ($543,071,378), the NOLs generated only by ESI's members who filed Missouri returns during the loss period ($408,373,826), or zero (if no NOL deduction is allowed). If this amount is greater than item C, then the deduction is equal to item C, because item E cannot be a negative number. ***Brown Grp. v. Administrative Hearing Comm'n***, 649 S.W.2d 874, 877 (Mo. banc 1983); *but see* § 143.431.5 ("For all years ending on or after July 1, 2002, federal taxable income may be a positive or a negative amount.") If item D is less than C, the unused amount is carried over to the following year. *See* 26 U.S.C. § 172(b) and 26 C.F.R. § 1.1502-21(b).

[6] C minus D.

[7] Joint stipulation of facts ¶ 4.

G	Missouri taxable income- all sources[8]	0	0	402,654,129
H	Apportionment percentage[9]	4.085%	4.085%	4.085%
I	Missouri taxable income[10]	0	0	16,448,421
J	Missouri income tax[11]	0	0	1,028,026

Conclusions of Law

Evidentiary issue - the Arnold and Iveson memos

Exhibit A to ESI's motion for summary decision in case #10-2337 RI consists of two memos, one from James Arnold to file dated February 7, 2001 ("the Arnold memo"), and the other from Todd Iveson to Juan Keller dated July 6, 2001 ("the Iveson memo"). The Arnold memo refers to an exchange of information and a meeting between a group of taxpayer-side representatives called the "Consolidated Return Regulation Group" ("CRRG"), of which Keller was a member, and a group of officials and employees representing the Director.[12] The Arnold memo appears to be a summary of what additional regulations the CRRG proposed the Director promulgate, and the responses by the Department of Revenue representatives.[13] The Iveson memo appears to explain drafts of proposed amendments (12 CSR 10-2.045 and 12 CSR 10-2.165),[14] drafted in response to the issues raised in the Arnold memo.[15] ESI claims the Iveson memo supports its argument, but the Director says that we "must not consider" the information in these memoranda because ESI provided no foundation for them,"[16] which we take to be an objection to their admission.

[8] E minus F.

[9] The percentage of a taxpayer's federal taxable income apportioned to Missouri. *See* § 143.451.2. Missouri statutory references are to RSMo 2000 unless otherwise indicated.

[10] G times H.

[11] I times the applicable Missouri income tax rate, .0625.

[12] ESI describes the group as taxpayers interested in the Director's consolidated return regulations. *See* ESI's Brief p. 12. Iveson appears to have written the memo on the Director's behalf, while Arnold is identified in his own memo as an attorney with the law firm of Bryan Cave.

[13] The paragraphs of the memo are numbered 1, 2, 4, 6, 7, 9, 10, and 11.

[14] All references to the CSR are to the Missouri Code of State Regulations as current with amendments included in the Missouri Register through the most recent update.

[15] As with the Arnold memo, the paragraphs are numbered 1, 2, 4, 6, 7, 9, 10, and 11.

[16] Director's response to ESI's motion for summary decision and Director's motion for summary decision ("Director's brief"), p. 20, n. 13.

For our proceedings, admissibility of documents such as these is addressed by § 536.070(9),[17] which provides in relevant part:

> Copies of writings, documents and records shall be admissible without proof that the originals thereof cannot be produced, if it shall appear by testimony or otherwise that the copy offered is a true copy of the original[.]

Here, ESI offers no "testimony or otherwise" that the memos are true copies of their originals. Furthermore, the Iveson memo as filed is incomplete because it refers to "attached…revised drafts of 12 CSR 10-2.045 and 10-2.165," and nothing was attached to that memo as filed. But we nonetheless exercise our discretion, overrule the Director's objection, and admit the memos into evidence because only by doing so can we fully address ESI's interpretation of 12 CSR 10-2.165(6), a matter we consider below under "ESI's second argument- 12 CSR 10-2.165(6) authorizes the deduction of the NOLs."

Background— calculation of federal and Missouri taxable income, application of net operating losses, taxation of affiliated groups of corporations and their members, and interplay of relevant laws

This case involves the interaction of federal and Missouri income tax laws, the application of those laws governing the creation and application of net operating losses, the taxation of affiliated groups of corporations and their members, and the interaction of those two areas of law.

How taxable income as determined for federal income tax purposes is calculated, and how that figure is used to determine Missouri taxable income

A corporation's taxable income for federal income tax purposes is defined in I.R.C. § 63. Subsection (a) of that statute provides the general definition:

> Except as provided in subsection (b),[18] for purposes of this subtitle, the term "taxable income" means gross income minus the

[17] RSMo 2013 Supp.
[18] Subsection (b) is titled "Individuals who do not itemize their deductions."

> deductions allowed by this chapter (other than the standard deduction).

A corporation's federal income tax return shows its taxable income on line 30 of IRS Form 1120.

The starting point for determining a corporation's income subject to Missouri income tax is § 143.431.1,[19] which provides:

> The Missouri taxable income of a corporation taxable under sections 143.011 to 143.996 shall be so much of its federal taxable income for the taxable year, with the modifications specified in subsections 2 to 4 of this section, as is derived from sources within Missouri as provided in section 143.451. The tax of a corporation shall be computed on its Missouri taxable income at the rates provided in section 143.071.

We discuss the modifications referred to in this statute under "ESI's fourth argument" below.

What "net operating losses" are, and how they are applied to federal and Missouri taxable income

A "net operating loss" is the excess of allowable deductions over gross income for a given tax year.[20] The federal net operating loss ("NOL") deduction is created by I.R.C. § 172(a), as follows:

> There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of
>
> (1) the net operating loss carryovers to such year, plus
>
> (2) the net operating loss carrybacks to such year.
>
> For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

[19] RSMo Supp. 2005.
[20] I.R.C. § 172(c); *see also* ***Eilian v. Director of Revenue***, 402 S.W.3d 566, 568 (Mo. banc 2013).

"Carryovers" are net operating losses that cannot be taken entirely in a given period, but may be taken in a later period.[21] "Carrybacks" are net operating losses that cannot be taken entirely in a given period, but may be taken in an earlier year, which necessarily requires the taxpayer to file an amended return for that year.[22] In other words, for federal tax purposes, if the taxpayer incurs a qualifying loss for a taxable year, it may carry over that loss and apply it to a future taxable year or carry back the loss to a prior tax year, depending on choices and circumstances beyond the scope of this decision.

I.R.C. § 172(b)(1)(A) states that NOLs may be carried back to each of the two taxable years preceding the taxable year of the loss, or carried forward to each of the twenty taxable years following the taxable year of the loss. With regard to how the NOL deduction is applied, I.R.C. § 172(b)(2) states that the entire amount of the NOL for any taxable year

> shall be carried to the earliest of the taxable years to which (by reason of [I.R.C. § 172(b)(1)]) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.

There is no Missouri counterpart to I.R.C. § 172. Instead, any net operating losses claimed by a Missouri taxpayer must be deducted from the taxpayer's gross income on the taxpayer's *federal* return; the resulting amount is both the "taxable income" shown on the federal return and the "federal taxable income" shown on the Missouri return.[23]

---

[21] *Black's Law Dictionary* (9th ed.) 242; *see also* ***Electrolux Holdings, Inc. v. United States***, 491 F.3d 1327, 1328 n. 2 (Fed. Cir.2007).

[22] *Black's Law Dictionary* (9th ed.) 242; *see also* ***Electrolux Holdings***, 491 F.3d at 1328 n.1.

[23] ***Eilian***, 402 S.W.3d at 570 n. 5.

Federal and Missouri taxation of affiliated groups and their members

I.R.C. § 1501 grants affiliated groups of corporations[24] the privilege of filing a federal consolidated return. The principle is explained in ***American Standard, Inc. v. United States***:

> The basic purpose behind allowing corporations to file consolidated returns is to permit affiliated corporations, which may be separately incorporated for various business reasons, to be treated as a single entity for income tax purposes as if they were, in fact, one corporation. Therefore…, the tax is computed solely on the basis of [the consolidated taxable income of the affiliated group].[25]

By electing to file a consolidated return, the members agree to be included in the group for federal tax purposes,[26] and both the affiliated group and its members agree to abide by the regulations promulgated by the Secretary of the Treasury pursuant to I.R.C. § 1502.[27]

Section 143.431.3(1) requires that an affiliated group desiring to file a Missouri consolidated return also file a federal consolidated return for the taxable year. Once the affiliated group has elected to file Missouri consolidated returns, it may withdraw or revoke that election only upon a substantial change in the law or regulations adversely changing tax liability under Chapter 143, or with the permission of the Director upon a showing of good cause.[28] Once such a withdrawal or revocation is made, the group may not file a Missouri consolidated return for five years thereafter except with the Director's approval, and subject to those terms and conditions as the Director may prescribe.[29]

An affiliated group or its members may not always benefit from filing a consolidated return. In that event, the affiliated group is held to the consequences of its choice, as described by the Court of Claims:

---

[24] An "affiliated group" is defined in I.R.C. § 1504. Generally, it is a group of corporations with common ownership.

[25] 602 F.2d 256, 261 (Ct. Cl. 1979).

[26] ***Centex Corp. v. United States***, 395 F.3d 1283, 1291 (Fed. Cl. 2005).

[27] I.R.C. § 1501.

[28] Section 143.431.3(2).

[29] *Id.*

> The election to file a consolidated return for an affiliated group inherently carries with it both advantages and disadvantages as compared to filing separate returns…. In promulgating consolidated return regulations, the Secretary is not obligated to offer a taxpayer all the benefits of consolidation while simultaneously preserving for it all deductions and benefits of separate returns. [T]he affiliated group that voluntarily elects to file a consolidated return must now take the bitter with the sweet.[30]

Application of net operating losses of affiliated groups and their members to federal and Missouri income taxes of those groups and members

The federal income tax deduction available to an affiliated group of corporations is determined by Treas. Reg. § 1.1502-21(a), which provides:

> The consolidated net operating loss deduction (or CNOL deduction) for any consolidated return year is the aggregate of the net operating loss carryovers and carrybacks to the year. The net operating loss carryovers and carrybacks consist of—
>
> > (1) Any CNOLs (as defined in paragraph (e) of this section) of the consolidated group; and
> >
> > (2) Any net operating losses of the members arising in separate return years.

In this case, ESI's NOL deduction claim for 2006 for its Missouri income taxes seeks to apply the federal income tax losses of its members that arose in the separate return years of 2001-2005, as allowed for federal income taxes by Treas. Reg. § 1.1502-21(a)(2). There is no Missouri regulatory counterpart to Treas. Reg. § 1.1502-21(a)(2). ESI presents several arguments why it is, nonetheless, entitled to deduct its members' prior-year, separate company net operating losses from its federal taxable income as shown on its Missouri income tax return. We set out those arguments in the next section.

[30] ***Garvey, Inc. v. United States***, 1 Cl. Ct. 108, 116 (Cl. Ct. 1983).

Our approach to the case

We believe the simplest way to understand this case is this: ESI reported one figure, $481,326,467, as taxable income on its 2006 federal return,[31] then reduced that figure by the amount of the net operating losses some of its members had incurred in years before 2006, years in which those members joined in ESI's federal consolidated returns but had filed separate company Missouri returns. ESI then reported the resulting figure, $18,606,843, as federal taxable income on its 2006 Missouri income tax return.[32] It offers these reasons why it was entitled to do so:

1. The Director was directed by the General Assembly to promulgate a regulation enabling an affiliated group filing a consolidated return to deduct the NOLs of its members that arose in separate return years;

2. 12 CSR 10-2.165(6) provides for the utilization of NOLs of members incurred in prior, separate company years based upon like treatment under federal law;

3. This Commission's decisions in ***Kerr-McGee Refining Corp. v. Director of Revenue***[33] and ***Cooper Industries, Inc. v. Director of Revenue***[34] provide for the utilization of NOLs in the manner sought by ESI;

4. Section 143.431.3(5) constitutes a modification to federal taxable income of the sort referred to in § 143.431.1;

5. Even if Missouri law does not provide for ESI's utilization of the NOLs in the manner sought, the Director's assessment must be abated because a decision upholding the assessment would be an "unexpected decision" under § 143.903; and

6. The Director's assessment must be abated because it is based on the Director's change in policy and interpretation of law.

These six arguments are set out below under applicable subheadings. We set out the Director's arguments, and our respective analyses, under those subheadings as well. We also set

[31] Finding of fact 10.
[32] Finding of fact 11. The amounts were later amended by IRS audits, as described in our findings of fact.
[33] No. 93-000717 RI (Missouri Admin. Hearing Comm'n, Mar. 29, 1994).
[34] No. 98-2920 RI (Missouri Admin. Hearing Comm'n, Aug. 9, 2000).

out a seventh argument, one ESI says it did not make, that the Director calls ESI's "equitable argument." We agree with the Director that the argument was made, and give it its own subheading, "ESI's seventh argument— ESI is entitled to claim the prior-year, separate company NOLs (ESI's equitable argument)." Following those analyses, we set out three observations that did not fit in the above subheadings.

ESI's first argument: The Director was directed by the General Assembly to promulgate a regulation enabling an affiliated group filing a consolidated return to deduct the NOLs of its members that arose in separate return years

ESI argues that §§ 143.431.3(5) and 143.961.2, read together, constitute a direction from the General Assembly to promulgate a regulation, as it put it, "treating Missouri taxpayers filing consolidated returns the same manner as they are treated for federal income tax purposes."[35] The actual regulation ESI seeks is much narrower— it only wants a Missouri regulation allowing it to deduct its prior-year, separate company NOLs in the manner that Treas. Reg. 1.1502-21(a)(2) allows it to do for federal income taxes. We look at each statute to evaluate ESI's argument.

Section 143.431.3(5)

Section 143.431.3(5), ESI argues, "provides express authority" for such a regulation. It states:

> The director of revenue may prescribe such regulations not inconsistent with the provisions of this chapter as he may deem necessary in order that the tax liability of any affiliated group of corporations making a Missouri consolidated income tax return, and of each corporation in the group, before, during, and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the Missouri taxable income derived from sources within this state and in order to prevent avoidance of such tax liability.

[35] ESI's motion for summary decision, proposed findings of fact, proposed conclusions of law, and brief ("ESI's brief"), p. 14.

The statute does provide, generally, broad authority to promulgate regulations concerning the tax reporting and liability of corporations filing consolidated returns, but also adds a limitation; those regulations must be "not inconsistent" with the provisions of Chapter 143. Also, there is no direction or command by the General Assembly in § 143.431.3(5) to the Director to promulgate *any* regulation, never mind the one ESI argues the Director has been directed to promulgate—because, as the statute begins, "The director of revenue *may* prescribe such regulations…." "May" means an option, not a mandate.[36]

Section 143.961.2

What direction the General Assembly provided, if any, is found in § 143.961.2. It reads as follows:

> The rules and regulations prescribed by the director of revenue shall follow as nearly as practicable the rules and regulations of the Secretary of the Treasury of the United States or his delegate regarding income taxation. Such construction of sections 143.011 to 143.996 will further their purposes to simplify the preparation of income tax returns, aid in their interpretation through use of federal precedents, and improve their enforcement.

The most applicable federal regulation to this case is Treas. Reg. § 1.1502-21(a), which we discuss above under "Application of net operating losses of affiliated groups and their members to federal and Missouri income taxes of those groups and members." Subsection (2) of that regulation does, at the federal level, precisely what ESI wants done at the Missouri level: allows the deduction by an affiliated group of corporations for the group's consolidated return year of net operating losses of its members arising in separate return years.

However, there are three problems with reading § 143.961.2 as a "direction" to promulgate a deduction for prior-year, separate company NOLs. The first problem is that

[36] ***S.J.V. ex rel. Blank v. Voshage***, 860 S.W.2d 802, 804 (Mo. App. E.D. 1993).

§ 143.961.2 does not *direct* the Director to promulgate any regulation; rather, it requires the Director's regulations to "follow as nearly as practicable the rules and regulations of the Secretary of the Treasury of the United States or his delegate regarding income taxation." An example of a direction from the General Assembly to the Director to promulgate such a regulation is § 143.183.4, regarding Missouri taxation of personal service income of professional athletes and entertainers, which provides as follows: "The director *shall by rule establish* the method of determining the portion of personal service income of such persons that is allocable to Missouri." (Emphasis added.) There is no such language in § 143.961.2.

The second problem with construing § 143.961.2 as a command to the Director to promulgate a regulation is that the statute has been construed in an entirely different way by the Supreme Court. In ***Kidde America, Inc. v. Director of Revenue***,[37] the taxpayer was the parent of an affiliated group of corporations. During the taxable year, it sold a subsidiary and realized a net gain from the sale. It reported the gain on its federal consolidated return and on its separate company Missouri return.

After the deadline for electing to file a Missouri consolidated return as set out in 12 CSR 10-2.045(13) had passed[38] (but before the three-year period for filing an amended return set out in § 143.801.1 had passed), the taxpayer realized that its accountants had misadvised it regarding the decision to file a Missouri separate return, and overpaid its Missouri taxes as a result. It filed an amended return, electing therein to file a consolidated return, and claimed a refund of the taxes saved as a result. The Director denied the refund on the ground that the deadline of 12 CSR 10-2.045(13) had passed. The taxpayer appealed the decision to this Commission, which denied its claim. Then it appealed our decision to the Supreme Court, which reversed.

[37] 198 S.W.3d 153 (Mo. banc 2006).

[38] 12 CSR 10-2.045(13) provides that the election to file a Missouri consolidated return must be exercised by the filing of such a return on or before the due date (including extensions of time) for the filing of the common parent's separate Missouri return.

In its opinion, the Court first noted that 12 CSR 10-2.045(13) had a similar federal counterpart, Treas. Reg. 1.1502-75(a)(1). However, another federal regulation, Treas. Reg. (added a space) 301.9100-3, allowed for the possibility of relief to a taxpayer in this situation if the taxpayer could show that it acted reasonably and in good faith. There was no Missouri regulation comparable to Treas. Reg. 301.9100-3. Had such a regulation existed, the taxpayer would have qualified for a good faith exception of the type set out in Treas. Reg. 301.9100-3(b)(1)(v), because it "reasonably relied on a qualified tax professional…and the tax professional failed to make, or failed to advise the taxpayer to make, the [relevant] election."[39]

Applying § 143.961.2, the Court held that the Director failed to "follow as nearly as practicable the rules and regulations of the Secretary of the Treasury of the United States or his delegate regarding income taxation" by not promulgating a regulation comparable to Treas. Reg. 301.9100-3. That failure, the Court held, rendered the Director's regulatory deadline of 12 CSR 10-2.045(13) unenforceable. As a result, the Court reversed this Commission's decision and held that the refund claim had to be allowed.[40]

The third problem with § 143.961.2 as raised by the Supreme Court in ***Kidde America*** is its statement (citing ***Armco Steel Corp. v. State Tax Comm'n***,[41] which we discuss below) that "section 143.961.2 does not require the Director to follow federal regulations if to do so will change the substantive rules of Missouri law."[42] As we discuss below under "Our first observation," deductions are created by the General Assembly through statute, not by the Director through regulation. Thus, any direction to "follow federal regulations" (which ESI interprets to mean create such regulations) must necessarily stop before such a following changes Missouri substantive law—in this case, creates a deduction the General Assembly did not create.

[39] 198 S.W.3d at 155.
[40] *Id*.at156.
[41] 580 S.W.2d 242 (Mo. banc 1979).
[42] ***Kidde America***, 198 S.W.3d at 155, *citing* ***Armco Steel***, 580 S.W.2d at 245.

That being said, had ESI relied on the holding in ***Kidde America***, the result in this case might be different. The parallels are clear: in that case, as in this one, the Director had failed to promulgate a regulation comparable to a federal regulation. And in both cases, had the Director promulgated such a regulation, the taxpayer would receive the relief it sought. Yet ESI expressly disclaims such an argument, and argues instead that 12 CSR 10-2.165(6) is the regulation allowing it to deduct prior-year, separate company NOLs.[43] We will not consider an argument expressly disclaimed by a party.[44]

The only other reported Missouri case referencing § 143.961.2 is ***M.V. Marine Co. v. State Tax Comm'n***, which noted the statute "*empowers* the director of revenue to issue rules and regulations to aid in the construction and interpretation of Chapter 143."[45] "Empowering" is very different from "directing."

A review of Supreme Court cases applying § 143.961.2's predecessor statute, § 143.200,[46] further undermines ESI's argument. In ***Mobil Oil Corp. v. State Tax Comm'n***,[47] the Director had promulgated a regulation, M.R. 140.3, limiting the amount an oil and gas producer could claim as a depletion allowance (effectively the same as a deduction) to the amount of capital originally invested.[48] Mobil Oil claimed the regulation violated § 143.200 because it contradicted federal

---

[43] Petitioner's reply brief p. 6, n. 5 ("[12 CSR 10-2.165(6)] itself requires taxpayers to follow the relevant Treasury regulations. *Thus, Petitioner is not engaged in an attempt to amend substantive Missouri law in the manner described in [**Kidde America**]*." (Emphasis added.) We also disagree with ESI's assertion that ***Kidde America*** describes an attempt to amend substantive law. To the contrary, the Supreme Court made it clear that it was not making any change to the law, but was denying the Director the power to enforce his own regulatory deadline (12 CSR 10-2.045(13)) due to his failure to adopt a regulation comparable to Treas. Reg. 301.9100-3 that, if promulgated, would have ameliorated the consequences of the regulatory deadline. *See* ***Kidde America***, 198 S.W.3d at 155-56.

[44] *See* ***City of Branson v. Hotels.com, LP***, 396 S.W.3d 378, 385 (Mo. App. S.D. 2013).

[45] 606 S.W.2d 644, 650 n.7, *abrogated on other grounds by* ***Goldberg v. State Tax Comm'n***, 639 S.W.2d 796, 803 (Mo. 1982).

[46] RSMo 1959. At all relevant times, § 143.200 read: "The director of revenue may prescribe reasonable rules and regulations for administration of the provisions of the laws relating to the levy, assessment, collection and payment of taxes based on incomes. Such rules and regulations shall follow as nearly as practicable the rules and regulations prescribed by the United States government on income tax assessments and collections."

[47] 513 S.W.2d 319 (Mo. 1974).

[48] *Id.* at 321.

depletion laws that did not so limit the allowable depletions. The Court disagreed, holding that § 143.200 did not delegate the power to promulgate rules of substantive law to the Director, and culminated with this simple statement—"Missouri law is different from federal law."[49]

Mobil Oil was cited by the Court in ***Armco Steel Corp. v. State Tax Comm'n.*** Armco Steel was a corporation that had income subject to Missouri taxation. It was also part of an affiliated group of corporations that, along with its subsidiaries, filed a federal consolidated return for that year.[50] In the taxable year (1969), Armco Steel and its subsidiaries paid $12,010,748.42 in federal income taxes. Under § 143.040-1,[51] it could deduct a proportionate share of those taxes[52] from its Missouri taxable income.[53]

Instead, Armco Steel claimed a deduction of the proportionate share of the amount it would have paid in federal taxes had it filed those taxes as a separate entity, or $17,358,029.90. Its justification for the claim was that some of its subsidiaries had sustained losses, and it (Armco Steel) was entitled to recover what it had paid to those subsidiaries to cover those losses. The proper way to account for that expense, Armco Steel argued, was to calculate its Missouri taxes as if it had filed a separate company federal return.[54]

The Director disagreed and assessed additional taxes against Armco Steel, disallowing the additional deduction claim. The State Tax Commission agreed with the Director, but the circuit court reversed that decision. The Supreme Court reversed the circuit court's judgment. The Court held that § 143.040-1.1 allowed a taxpayer to deduct the proportionate share of what it

---

[49] *Id.* at 323.

[50] In 1969, Missouri law did not allow corporations to file consolidated returns. ***Armco Steel***, 580 S.W.2d at 243. Even if such filing had been permitted, none of Armco's subsidiaries had a presence in Missouri that required their filing Missouri returns. *Id.*

[51] RSMo 1959.

[52] The proportion was the percentage of its Missouri taxable income over its federal taxable income. Section 143.040-1.1.

[53] ***Armco Steel***, 580 S.W.2d at 243.

[54] *Id.*

actually paid in federal income taxes, not an amount based on a hypothetical separate company federal return.

The case also applied § 143.200 to Armco Steel's claim that Treas. Reg. 1.1502-33(d)(2)(i) recognized the method of allocation Armco Steel used to calculate its hypothetical federal tax liability, and under § 143.200, should be followed by the Director.[55] The Court rejected Armco Steel's argument, holding that, notwithstanding § 143.200, the federal regulation could not be applied if to do so would change the substantive rules of Missouri law.[56]

In summary, we find no direction from the General Assembly to the Director to promulgate the regulation ESI seeks. To the contrary, we see the Supreme Court in ***Mobil Oil*** and ***Armco Steel*** applying the predecessor statute to § 143.961.2, and disallowing taxpayers' attempts to modify a figure it calculated and reported on its federal return in order to support their claim of what they owed in Missouri income tax.[57]

ESI's second argument: 12 CSR 10-2.165(6) provides for the utilization of the NOLs of members incurred in prior-year, separate company years based upon like treatment under federal law.

The Missouri regulation that ESI argues does the same thing as does Treas. Reg. 1.1502-21(a)(2),[58] i.e., creates the deduction for prior-year, separate company NOL deductions, is 12 CSR 10-2.165(6), which provides in relevant part:

> When a member of an affiliated group of corporations that files a federal consolidated return files a separate Missouri return…, then the carryover attributes for the Missouri return may be different from the carryover attributes for the federal consolidated return. When the filing status or combination for the Missouri return for any taxable year is different from the federal filing status or combination for that taxable year, the taxpayer must follow the

[55] *Id.* at 245.
[56] *Id.*
[57] We discuss taxpayers' attempts to modify federal income tax figures on their Missouri returns below under "The Supreme Court has, consistently, rejected taxpayers' attempts to alter federal income tax figures on their Missouri tax returns."
[58] See "Application of net operating losses of affiliated groups and their members to federal and Missouri income taxes of those groups and members" above regarding Treas. Reg. 1.1502-21.

> federal Internal Revenue Code (I.R.C.) and regulations as they would apply to the facts and circumstances for the Missouri return. Under no circumstances may the same loss or deduction be used more than once for Missouri purposes. No loss or deduction will be allowed unless the taxpayer provides a schedule identifying the source of each loss or deduction.

Interpreting 12 CSR 10-2.165(6)

Where Treas. Reg. 1.1502-21 is (at least by comparison with other Treasury Regulations concerning NOLs) straightforward, the Director's regulation is not. ESI offers this interpretation of 12 CSR 10-2.165(6)'s ambiguity:

> The Regulation clearly recognizes that where a member of an affiliated group files separate company Missouri returns, the carryover attributes of NOLs may be different between the federal consolidated return and the Missouri consolidated return. In such a situation, and consistent with the requirements of Section 143.961.2, the taxpayer must follow the requirements under Federal tax law. The applicable regulation, Treas. Reg. § 1.1502-21, provides that the consolidated NOL deduction may include NOLs of affiliated group members that filed separate returns in prior years….[59]

However, we find this interpretation to be tortured at best. To evaluate ESI's claims, we look at 12 CSR 10-2.165(6) ourselves, sentence by sentence or, at times, clause by clause.

The first clause of the first sentence ("When a member of an affiliated group of corporations that files a federal consolidated return files a separate Missouri return") does describe the status of ESI's members who filed separate Missouri returns, *in 2001-2005*.[60] But as the Director points out, this case concerns the adjustment the Director made to ESI's *2006* Missouri return. The sentence continues: "…then the carryover attributes for the Missouri return may be different from the carryover attributes for the federal consolidated return." This seems

[59] ESI's brief p. 15.
[60] See findings of fact 5 and 10 above.

only to describe a possible state of being, i.e., what those attributes may be in different circumstances.[61]

The next sentence begins, "When the filing status or combination for the Missouri return for any taxable year is different from the federal filing status or combination for that taxable year…." We interpret "filing status or combination" as referring to whether an affiliated group has filed a consolidated return, or its members filed separate returns.[62] As with the first sentence, the situation described by this clause (when the filing status for the Missouri return is different from the filing status for the federal return for the same taxable year) is that of ESI's members in 2001-05, not 2006-07.

The sentence continues with a command: "*the taxpayer must follow* the federal Internal Revenue Code (I.R.C.) and regulations as they would apply to the facts and circumstances for the Missouri return." (Emphasis added.) This command to the taxpayer is nothing like Treas. Reg. 1.1502-21(a)'s particularized definition of "consolidated net operating loss" as the combination of consolidated NOLs of the consolidated group *and* NOLs of its members arising in separate return years. Moreover, even if we read it as ESI urges us to, the Missouri regulation would be inapplicable to ESI's situation in 2006 or 2007.

Thus, when we attempt to give the words of the regulation their plain and ordinary meaning, we are left with a description of a situation ESI was not in for 2006 and 2007, a statement of being that performs no function we can discern, and a command to the *taxpayer* to follow the Internal Revenue Code and Treasury Regulations. The remainder of 12 CSR 10-2.165

[61] The term "carryover attribute" is not used, much less defined, in any published Missouri case, or in any Missouri statute or regulation other than 12 CSR 10-2.165. Nor do we find its use in the United States Code, the Code of Federal Regulations, or any federal case (or case from another state) other than ***Dover Corp. & Subsidiaries v. Commissioner of Internal Revenue***, 122 T.C. 324, 349 (T.C. 2004), and it is not discussed there.

[62] *See* ***Suburban Newspapers of Greater St. Louis, Inc. v. Director of Revenue***, 975 S.W.2d 107, 109 (Mo. banc 1998).

has no application to this analysis. "Ambiguous," therefore, certainly describes 12 CSR 10-2.165(6).

Where possible, words in a regulation are given their plain and ordinary meaning.[63] But when, as here, the intent of a regulation cannot be determined because its language is ambiguous, we give it a reasonable interpretation and construction in a manner consistent with the provision's objective.[64] The stated purpose of 12 CSR 10-2.165, as set out at the beginning of the regulation, is to "explain the proper Missouri income tax treatment of net operating losses by corporations." That purpose broadly describes the subject matter, but it does not help ESI's argument that the regulation *creates* an NOL deduction of the type created by Treas. Reg. 1.1502-21(a)(2). Therefore, neither the plain language of 12 CSR 10-2.165(6) nor its purpose supports ESI's position.

The Iveson memo as interpreting 12 CSR 10-2.165(6)

ESI offers another interpretive tool, the Iveson memo, referred to above under "Evidentiary issue: the Arnold and Iveson memos." As we state there, the Iveson memo appears to explain drafts of proposed amendments to 12 CSR 10-2.045 and 12 CSR 10-2.165. ESI says that, per Iveson's memo, 12 CSR 10-2.165(6) "was added to the Regulations to address the issue in this case, and expressly took into account this Commission's decision in ***Cooper Industries***[65] in promulgating the Regulation."[66]

---

[63] ***Beverly Enters.-Missouri, Inc. v. Department of Soc. Servs., Div. of Med. Servs.,*** 349 S.W.3d 337, 352 (Mo. App. W.D. 2008).

[64] ***Department of Soc. Servs., Div. of Med. Servs. v. Senior Citizens Nursing Home District of Ray County***, 224 S.W.3d 1, 18 (Mo. App. W.D. 2007).

[65] "Cooper Industries" refers to ***Cooper Inds., Inc. v. Director of Revenue***, No. 98-2920 (Missouri Administrative Hearing Comm'n, [date]). We discuss this case below under "*Argument # 3- Our decisions provide for the utilization of the NOLs in the manner sought by ESI*."

[66] ESI's proposed conclusion of law number 9, p. 13 of ESI's brief; also found at ESI's brief p. 18.

ESI, however, misreads what Iveson actually said in his memo. To understand what he said, we first set out what he was responding to—paragraph 9 of the Arnold memo. That paragraph reads in relevant part:

> **Prepare regulations implementing a Missouri separate return limitation year (SRLY) [67] based upon and similar to the Federal rules and regulations relating to the same subject.**
>
> The Group explained its position regarding the SRLY regulations and the possible implications to the state if as a result of the GM case more taxpayers elect to file consolidated returns in Missouri.
>
> The Department acknowledged that it had not given much consideration to SRLY and would be interested in the Group's assistance in the preparation of pro-forma tax return examples which would show the effects of SRLY on Missouri consolidated returns.

The subheading, in bold, sets out what the CRRG wanted the Director to do and a summary of the subject matter of what was discussed below it. Iveson's memo replied in relevant part:

> Attached are revised drafts of 12 CSR 10-2.045 and 10-2.165. These attachments show the changes made in this round of changes only.
>
> * * *
>
> 9. The SRLY regulation appears in the revised 12 CSR 10-2.165 as new section 6. We have deleted the old section 3 to reflect Cooper Industries.

In other words, the first sentence states that the revised section 6 of 12 CSR 10-2.165 is "the SRLY regulation." ESI argues that, based on Iveson's statement, that regulation, as promulgated and existing at all relevant times, is "the SRLY regulation," and therefore allows the prior-year, separate company deduction ESI claims. Aside from the fact that, as we set out

[67] "SRLY" is an acronym meaning "separate return limitation year." A "separate return year" is "a taxable year of a corporation for which it files a separate return." Treas. Reg. § 1.1502-1(e). A "separate return limitation year" is a separate return year, except for situations described in Treas. Reg. § 1.1502-1(f)(2) and (3). *Id.* 1.1502-1(f). The acronym is commonly used in situations where federal taxpayers are claiming prior-year, separate company NOL deductions under Treas. Reg. 1.1502-21(b)(2).

above, the regulation does not say what ESI says it says, ESI did not attach the "revised draft of 10-2.165" to which Iveson referred in the first sentence of his memo. We have no way of knowing how similar that draft is to 12 CSR 10-2.165(6) as finally promulgated.

Then in an attempt to bolster its argument, ESI misreads the second sentence of that paragraph. It does not refer to section 6, but instead refers to deleted language formerly denominated as section 3, which language was, as Iveson explained, deleted because of this Commission's decision in ***Cooper Industries***.[68] Iveson's explanation regarding section 3 is consistent with this Commission's decision in ***Cooper Industries***, where we declared that section to be "inconsistent with the statutes."[69] Therefore, ESI's argument that 12 CSR 10-2.165(6) was intended in any way to reflect the issue raised by ***Cooper Industries*** is refuted by a plain reading of Iveson's memo. We discuss ***Cooper Industries*** under "ESI's third argument" below.

The Director's interpretation of 12 CSR 10-2.165(6)

The Director does not offer much in the way of interpretation of this regulation, but he does make a single, telling point by using its plain language— "When the filing status or combination for the Missouri return *for any taxable year* is different from the federal filing status or combination *for that taxable year*, the taxpayer must follow the federal Internal Revenue Code (I.R.C.) and regulations as they would apply to the facts and circumstances for the Missouri return" (emphasis added). He then points out that the federal and Missouri filing status of ESI's subsidiaries which incurred the NOL were different in 2001 through 2005, *not* 2006 and 2007, the years for which ESI claims the deductions.

[68] Former section 3 of 12 CSR 10-2.165 read: "Net operating loss from a year when the loss company was not subjected to taxation by Missouri may not be used to determine Missouri taxable income." *See* ***Cooper Inds.*** at *5. The deletion of former paragraph 3 and the addition of new paragraph 6 was done by an amendment to 12 CSR 10-2.165 filed Jan. 10, 2002, 27 Mo. Register 338, said amendment made effective July 30, 2002, 27 Mo. Register 922.

[69] ***Cooper Inds.*** at *5.

We defer to an agency's interpretation of its own regulation as long as such interpretation does not expand upon, narrow, or result in an interpretation that is inconsistent with the plain and ordinary meaning of the words used in the regulation.[70] Here, the Director's interpretation does none of those things. We conclude that the Director's interpretation of his own regulation is not only entitled to deference, but it makes more sense than ESI's interpretation of it.

ESI's counterargument—the Director's interpretation renders parts of the regulation into surplusage

In its reply brief, ESI argues that the Director's interpretation of the regulation renders substantial parts of the regulation as "mere surplusage." The allegedly surplus parts of the regulation are emphasized below:

> When a member of an affiliated group of corporations that files a federal consolidated return files a separate Missouri return…, *then the carryover attributes for the Missouri return may be different from the carryover attributes for the federal consolidated return.* When the filing status or combination for the Missouri return for any taxable year is different from the federal filing status or combination for that taxable year, the taxpayer must follow the federal Internal Revenue Code (I.R.C.) and regulations as they would apply to the facts and circumstances for the Missouri return. *Under no circumstances may the same loss or deduction be used more than once for Missouri purposes. No loss or deduction will be allowed unless the taxpayer provides a schedule identifying the source of each loss or deduction.*

ESI continues: "Under the Director's interpretation, much of this regulation would be surplusage. For an example, if an affiliated group were never entitled to use the tax attributes of a member formerly filing separate company Missouri returns, there would be no need for the provisions stating that carryover attributes may be different from those on the federal return since in all cases they would be the same."

[70] ***State ex rel. Office of Public Counsel v. Missouri Pub. Serv. Comm'n***, 301 S.W.3d 556, 566 (Mo. App. W.D. 2009); ***Beverly Enters.-Missouri, Inc.,*** 349 S.W.3d at 352.

While we acknowledge the canon of regulatory interpretation that all the language contained in the regulation must be given effect, and none is to be disregarded,[71] another such canon says that we are to give the words of a statute (or here, a regulation) a reasonable meaning, not an absurd or strained reading.[72] As we state above, the first highlighted language, referring to the potential difference between the carryover attributes of Missouri separate returns versus federal consolidated returns, has no language of command or prohibition; it merely states what attributes might be found in a particular situation. The first sentence of the second highlighted language assumes an entitlement ESI has not proven here – that it is entitled to use the NOL deduction even once. Finally, the last sentence of the regulation has no relevance here because the issue is not whether ESI "showed its work" in establishing its NOL deduction by attaching a schedule, but whether Missouri law entitles it to the deduction in the first place.

To summarize, ESI has failed to show that 12 CSR 10-2.165(6) allows the utilization of NOLs in the manner ESI seeks.

ESI's third argument- This Commission's decisions in Kerr-McGee Refining Corp. and Cooper Industries provide for the utilization of the NOLs in the manner sought by ESI.

ESI cites our decisions in ***Kerr-McGee Refining Corp. v. Director of Revenue*** and ***Cooper Inds., Inc. v. Director of Revenue*** as authority for its deduction of its prior-year, separate company NOLs. In ***Kerr-McGee Refining Corp***. ("***KMRC***"), Triangle Refineries, Inc. ("Triangle") was a wholly owned subsidiary of KMRC.[73] Triangle incurred net operating losses in 1983 through 1987.[74] It applied some, but not all, of those losses on its separate company Missouri return.[75] Then, KMRC acquired all of Triangle's assets in an I.R.C. § 332 merger of

[71] ***Beverly Enters.-Missouri,*** 349 S.W.3d at 352.
[72] ***J.S. v. Beaird***, 28 S.W.3d 875, 876 (Mo. banc 2000).
[73] ***KMRC*** at *1.
[74] *Id.*
[75] *Id.*

the two corporations.[76] KMRC then filed a separate company Missouri return, in which it applied the unused portion of Triangle's NOLs.[77] The Director disallowed KMRC's deduction claim, and KMRC appealed.[78] This Commission concluded KMRC was indeed entitled to use Triangle's NOLs because I.R.C. § 381(a) and (c) provide that an acquiring corporation such as KMRC succeeds to and takes into account the NOLs of a distributor corporation such as Triangle.[79]

The facts and the holding of ***Cooper Industries*** closely parallel ***KMRC***. As in ***KMRC***, Cooper Industries claimed deductions for NOLs it obtained from subsidiaries that had merged into it, thus triggering the claim to the subsidiaries' NOLs under I.R.C. § 381.[80] And as in ***KMRC***, Cooper filed separate company, not consolidated, returns.[81] And, as in ***KMRC***, this Commission held that Cooper Industries was entitled to deduct its former subsidiary's NOLs from its taxable income.[82]

*Why **KMRC** and **Cooper Industries** are not authority for ESI's position*

However, there are several issues precluding our following these cases as authority. First, this Commission's previous decisions do not have precedential authority.[83] At best, our decisions in ***KMRC*** and ***Cooper Industries*** can be an instructive tool in guiding our analysis, where the relevant facts are substantially similar. There is, however, a distinct factual difference between those cases and this one. As the Director points out, KMRC and Cooper Industries were claiming the NOLs as a deduction on their separate company returns, not their consolidated returns.

---

[76] *Id.* A "merger" under § 332 is actually a liquidation of the subsidiary, whose assets pass to the parent without recognition of gain or loss to the parent. See I.R.C. § 332(a)-(b).
[77] *Id.* at *2.
[78] *Id.*
[79] *Id.* at *5.
[80] ***Cooper Inds.***, *1-2, 2-3.
[81] *Id.* *2, 3.
[82] *Id.* at *6.
[83] ***Central Hardware Co. v. Director of Revenue***, 887 S.W.2d 593, 596 (Mo. banc 1994).

Second, there is an equally distinct legal difference between those cases and this case. Unlike ESI in this case, KMRC was not trying to claim the NOLs of an ongoing corporation, but claimed them as a result of I.R.C. § 381(a) and (c) and § 332, which came into effect because KMRC acquired Triangle's assets through liquidation.[84] Similarly, Cooper Industries acquired at least one of the subsidiaries whose acquisition was at issue pursuant to I.R.C. § 332,[85] and the Commissioner noted in his conclusions of law that Cooper Industries met its reporting burden under I.R.C. § 381.[86]

ESI's fourth argument: Section 143.431.3(5) modifies what constitutes "federal taxable income" in § 143.431

ESI raises this argument for the first time in its reply brief, under the subheading "The Director's interpretation of section 143.431 does not take into account the entirety of the statute."[87] Section 143.431.1 defines the Missouri taxable income of a corporation to be "so much of its federal taxable income, for the taxable year, with the modifications specified in subsections 2 to 4 of this section, as is derived from sources in Missouri…." For this argument, ESI focuses on the language, "*with the modifications specified in subsections 2 to 4 of this section*," and argues that 143.431.3(5) is precisely such a modification. In order to evaluate ESI's argument, we look at subsections 2 to 4 to see what they say with regard to modifying what constitutes federal taxable income.

What we find are several provisions that, unquestionably, modify what constitutes "federal taxable income." They are:

[84] I.R.C. § 381(a)(1) and (c)(1) provide in relevant part: "In the case of the acquisition of assets of a corporation by another corporation, in a distribution to such other corporation in which section 332 applies…, the acquiring corporation shall succeed to and take into account…the net operating loss carryovers determined under section 172…." Our decision in ***Kerr-McGee*** expressly referred to sections 332 and 381.

[85] ***Cooper Inds***. at *3.

[86] *Id.* at *6.

[87] ESI's reply brief pp. 3-5.

- Adding or subtracting from federal taxable income the modifications to gross income provided in § 143.121, except for § 143.121.2(5);[88]

- Increasing or reducing federal itemized deductions as provided in § 143.141;[89]

- Subtracting from federal taxable income corporate dividends from sources within Missouri, to the extent they are included in federal taxable income;[90] and

- Adding to federal taxable income the amount of the net operating loss modification for each loss year as to which a portion of the net operating loss deduction is attributable, if a net operating loss deduction is allowed for the taxable year.[91]

ESI argues that § 143.431.3(5) is also such a modification. For comparison's sake, we set it out again.

> The director of revenue may prescribe such regulations not inconsistent with the provisions of this chapter as he may deem necessary in order that the tax liability of any affiliated group of corporations making a Missouri consolidated income tax return, and of each corporation in the group, before, during, and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the Missouri taxable income derived from sources within this state and in order to prevent avoidance of such tax liability.

A "modification" is defined in relevant part as "the act or action of changing something without fundamentally altering it."[92] By that definition, the bulleted provisions from § 143.431.2 and .4 listed above undoubtedly *modify* what constitutes "federal taxable income" because they add or subtract from it, or increase or reduce federal itemized deductions. By contrast, § 143.431.3(5), on its face, does not perform any of those modifications, but merely authorizes the Director to promulgate regulations.

---

[88] Section 143.431.2. Section 143.121.1 defines "Missouri adjusted gross income of a resident individual" as "the taxpayer's federal adjusted gross income subject to the modifications in this section." Subsection 2 lists items to be added to federal adjusted gross income, subsections 3 and 6 list items to be subtracted from federal adjusted gross income, and subsections 4 and 5 list items to be added to or subtracted from federal adjusted gross income. We therefore interpret "modification" as applied in this section as adding to or subtracting from federal adjusted gross income.

[89] *Id*. The "applicable modifications" to itemized deductions in § 143.141 are reductions or increases in various amounts.

[90] *Id.*

[91] Section 143.431.4.

[92] *Webster's Third New Int'l Dictionary* 1452 (unabr. 1986).

ESI argues that § 143.431.3(5) modifies federal taxable income because it must be read *in pari materia* with the remainder of the statute.[93] We agree that it must be read *in pari materia* with the rest of § 143.431, but as we show above, such a reading does not do what ESI says it does. Instead, we find it more appropriate to read it *in pari materia* with the other provisions of § 143.431.3. Those other provisions:

- Provide when an affiliated group may elect to file a Missouri consolidated return (when the group files a federal consolidated return);[94]

- Provide what the "federal consolidated taxable income" of such an electing consolidated group shall be for the taxable year (the group's federal taxable income);[95]

- Set out the circumstances when an affiliated group electing to file a Missouri consolidated return as set out in § 143.431.3(1) may withdraw or revoke that election (upon substantial change in the law or regulations adversely changing tax liability under Chapter 143, or with permission of the Director upon the showing of good cause for such action);[96]

- Set out the period during which an affiliated group, having been allowed to revoke its election to file a consolidated Missouri return as set out above, may not then file a Missouri consolidated return (five years after withdrawing or revoking the election to file Missouri consolidated returns, except with the approval of the Director, and subject to such terms and conditions as he may prescribe);[97]

- State that no corporation that is part of an affiliated group of corporations filing a Missouri consolidated income tax return shall be required to file a separate Missouri corporate income tax return for the taxable year;[98] and

- State that for each taxable year an affiliated group of corporations filing a federal consolidated income tax return does not file a Missouri consolidated income tax return, for purposes of computing the Missouri income tax, the federal taxable

[93] ESI reply brief p. 4.
[94] § 143.431.3(1).
[95] *Id.*
[96] § 143.431.3(2).
[97] *Id.* While it does not affect our decision of the case, we note that, after ESI asked for and received permission to file separate Missouri returns starting in 2001 (thus committing its members to not file consolidated Missouri returns for tax years 2001-05 under § 143.431.3(2)), it nonetheless tried to file consolidated returns for 2004 and 2005, after having been refused permission to do so by the Director under § 143.431.3(2). The Director refused to allow the returns. *See* findings of fact 6-10.
[98] § 143.431.3(3).

> income of each member of the affiliated group shall be determined as if a separate federal income tax return had been filed by each such member.[99]

None of these provisions can be construed as a "modification" to what constitutes federal taxable income. Instead, they provide rules for when affiliated groups and their members can and cannot file consolidated or separate returns and, in two places, set out what the federal taxable income of the reporting corporation is to be when the group files a Missouri consolidated return, and when its members file Missouri separate company returns.

Reading § 143.431.3(5) *in pari materia* with those provisions, we see that it is what it looks like— a grant of authority to the Director to prescribe regulations to ensure that the tax liability of affiliated groups and their respective members may be "returned, determined, computed, assessed, collected, and adjusted" so as to determine their Missouri taxable income, and to prevent avoidance of their tax liability. Unlike §§ 143.431.2 and 143.431.4, it does nothing to modify federal taxable income.

Therefore, we must disagree with ESI's argument that § 143.431.3(5) can be said to modify federal taxable income in the manner ESI suggests.

ESI's fifth argument: the Director's assessment must be abated because any decision upholding the assessment would be an "unexpected decision" under § 143.903

Section 143.903 provides:

> 1. Any provision of law to the contrary notwithstanding, an unexpected decision by or order of a court of competent jurisdiction or the administrative hearing commission shall only apply after the most recently ended tax period of the particular class of persons subject to such tax imposed by chapters 143 and 144 and any credit, refund or additional assessment shall be only for periods after the most recently ended tax period of such persons.
>
> 2. The provisions of this section shall apply only to final decisions by or orders of a court of competent jurisdiction or the

[99] § 143.431.3(4).

> administrative hearing commission which are rendered after October 1, 1990, and which are determined by the court or the administrative hearing commission rendering the decision, or subsequently by a lower court or the administrative hearing commission, to be unexpected. For the purposes of this section the term "unexpected" shall mean that a reasonable person would not have expected the decision or order based on prior law, previous policy or regulation of the department of revenue.

ESI argues that the Director's assessment must be abated pursuant to § 143.903 because it "would overrule [this Commission's] decisions in ***Kerr-McGee*** and ***Cooper***, as well as the Director's regulation."[100] ESI correctly cites ***Lloyd v. Director of Revenue*** for the rule that a decision is "unexpected" for purposes of § 143.903 if it overrules a prior case or invalidates a previous statute, regulation or policy of Director of Revenue, and the decision was not reasonably foreseeable.[101]

Why this decision is not "unexpected"

However, this decision is not "unexpected" for purposes of § 143.903. First, as we set out above, our ***Kerr-McGee*** and ***Cooper Industries*** decisions are distinguishable on their facts from this case, as both taxpayers had an express federal statutory right to claim the NOLs of the subsidiaries that merged into them. Therefore, those decisions are not "overruled," as ESI claims.

Second, neither the law, policy, nor regulations have changed. ESI argues that 12 CSR 10-2.165(6) and § 143.431.3(5) create the deduction, and ***KMRC*** and ***Cooper Inds.*** recognize it. Therefore, ESI argues, these authorities have been "invalidated" by the Director's decision. But we disagree with ESI's argument regarding those authorities; there is no law remaining that the Director's decision invalidates.

[100] ESI's brief p. 20. ESI does not say which of the Director's regulations would be overruled by an adverse decision, but we assume it means 12 CSR 10-2.165(6).

[101] 851 S.W.2d 519, 522-23 (Mo. banc 1993).

ESI clearly errs in its stated belief that what Iveson said in his memo constitutes the Director's position regarding the interpretation of 12 CSR 10-2.165(6), not to mention the fact that it misread the memo's reference to ***Cooper Industries***. The fact that ESI misinterpreted and misapplied our decisions and misread Iveson's memo does not entitle it to claim that a reasonable person in its position would not have expected this decision.

ESI's sixth argument: the Director's assessment must be abated because it is based on the Director's change in policy or interpretation of law

Section 32.053 provides:

> Any final decision of the department of revenue which is a result of a change in policy or interpretation by the department effecting a particular class of person subject to such decision shall only be applied prospectively.

ESI argues that we should abate the Director's final decision—in effect, disagree with it and adopt ESI's position— because the Director's policies "are effectuated by the promulgation of regulations pursuant to the procedures set forth by the Missouri Administrative Procedure Act ["MAPA"]."[102] The regulation to which it refers is 12 CSR 10-2.165(6), and the violation of MAPA to which it, apparently, refers is a failure to amend that regulation in accordance with the MAPA. In other words, ESI says MAPA requires the Director to promulgate its position regarding prior-year, separate company NOLs as a rule, with the attendant process required for such promulgation set out in MAPA.

This is, we believe, a novel argument; none of this Commission's prior decisions referencing § 32.053 has ever discussed it, and we find no reference to § 32.053 in the published Missouri appellate decisions. That said, we reject it because, as we state above, 12 CSR 10-

[102] ESI's brief, p. 21.

2.165(6) (which is, of course, a rule under MAPA[103]) does not say what ESI says it says. Therefore, there has been no change in the rule so as to trigger the provisions of MAPA.

ESI's seventh argument- ESI is <u>entitled</u> to claim the prior-year, separate company NOLs (ESI's equitable argument)

While ESI does not identify it as a discrete argument, the Director points out ESI's *de facto* seventh argument—that ESI is *entitled* to deduct its members' prior-year, separate income net operating losses from its 2006 and 2007 Missouri returns, and that it would be wrong (or, inequitable) to not be able to deduct them. This argument takes several forms throughout ESI's arguments. First ESI argues that "the Director has denied the Group the right to use [prior year, separate-company NOLs], effectively arguing that by switching from filing Missouri…returns on a separate company basis to filing as part of a consolidated group, any unused NOLs 'disappear,' never to be used by any taxpayer."[104] Then, it characterizes the ability to use such NOLs as "the "fair result."[105] Then later, it refers to the Director's position as "result[ing] in the subject NOLs *never* being utilized by any taxpayer for Missouri income tax purposes, because such NOLs would simply 'disappear,' never to be used by any taxpayer."[106] (Emphasis in original.)

Why ESI's equitable argument fails

However, ESI cites no authority for its claim of right to the state NOL deduction, and any such claim is negated by settled Missouri law that deductions depend upon legislative grace and are allowable only to the extent authorized by statute.[107] As we point out above under "Federal and Missouri taxation of affiliated groups and their members," the election to file consolidated or

[103] ESI correctly cites the definition of "rule" under MAPA as "each agency statement of general applicability that implements, interprets, or prescribes law or policy, or that describes the organization, procedure, or practice requirements of any agency." Section 536.010(6) RSMo 2013 Supp.

[104] ESI's brief, pp. 2, 13.

[105] *Id*. p. 2.

[106] *Id*. pp. 16-17.

[107] ***Fidelity Sec. Life Ins. Co***., 32 S.W.3d at 529 (Mo. banc 2000).

separate returns carries both positive and negative potential consequences, and the taxpayer must, as the Court of Claims put it, "take the bitter with the sweet." [108]

Our first observation— Missouri income tax deductions cannot be created by regulation

The Supreme Court instructs that deductions are a matter of *legislative* grace and are allowable only to the extent allowed by statute.[109] ESI nonetheless claims that its right to the deduction in question is not based on a statute, but on a regulation, 12 CSR 10-2.165(6). We analyze the specific language of that regulation above under "ESI's second argument," and conclude that it did not do what ESI says it does. Here, we make a larger point—even if 12 CSR 10-2.165(6) had created the deduction that ESI claims, the Director would have exceeded his authority in creating it.

On first glance, this seems counterintuitive— an affiliated group's federal deduction for prior-year, separate company NOLs was created by federal regulation, and the Director is charged by § 143.961.2 with ensuring that his regulations follow the Treasury Regulations "as nearly as practicable." So, what would be the problem with the Director creating a deduction by regulation?

The problem arises, we think, from something the Missouri General Assembly did not do that Congress did—grant to the person administering the income tax the power to promulgate regulations that, "unlike ordinary Treasury Regulations, are legislative in character…."[110] As a

[108] ***Garvey, Inc.***, 1 Cl. Ct. at 116.

[109] ***Brown Grp***., 649 S.W.2d at 877, *cited in* ***Fidelity Sec. Life Ins. Co***., 32 S.W.3d at 529; ***Seltz v. Director of Revenue***, 934 S.W.2d 293, 295 (Mo. banc 1996); ***Matteson v. Director of Revenue***, 909 S.W.2d 356, 359 (Mo. banc 1995);

[110] ***Union Elec. Co. v. United States***, 305 F.2d 850, 854 (Ct. Cl. 1962), *citing* ***Charles Ilfeld Co. v. Hernandez***, 292 U.S. 62, 65 (1934) (applying former 26 U.S.C. § 2141(b)); *see also* ***Nichols v. United States***, 260 F.3d 637, 645 (6th Cir. 2001); ***Rite Aid Corp. v. United States***, 255 F.3d 1357, 1359 (Fed. Cir. 2001); ***Connecticut Gen'l Life Ins. Co. v. Commissioner of Internal Revenue***, 177 F.3d 136, 143 (3rd Cir. 1999).

result, Treasury regulations are "endowe[ed] with…the same stature as if specifically enacted by the Congress;" regulations of the Director lack this legislative character.[111]

The source of this power is I.R.C. § 1502, which reads:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

That language bears a distinct similarity to § 143.431.3(5), which we discuss above under ESI's first and fourth arguments. We compare the two statutes, side by side, here:

I.R.C. § 1502	**Section 143.431.3(5)**
The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.	The director of revenue may prescribe such regulations not inconsistent with the provisions of this chapter as he may deem necessary in order that the tax liability of any affiliated group of corporations making a Missouri consolidated income tax return, and of each corporation in the group, before, during, and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the Missouri taxable income derived from sources within this state and in order to prevent avoidance of such tax liability.

We can see that the Missouri statute is quite similar to the federal one, but differs in three material ways:

- It changes "shall prescribe…" to "may prescribe…;"
- it adds the phrase "not inconsistent with the provisions of this chapter;" and

[111] ***Robbins Door & Sash Co. & Subsidiaries v. Commissioner of Internal Revenue***, 55 T.C. 313, 320 (Tax Ct. 1970).

- it changes "reflect the income-tax liability and the various factors necessary for the determination of such liability" to "reflect the Missouri taxable income derived from sources within this state."

We discussed the "shall" to "may" change above under "ESI's first argument," to refute ESI's argument that the General Assembly ordered the Director to promulgate the regulation ESI seeks. Our conclusion also reflects the holdings of the federal courts we set out above, noting the grant of power by Congress to the Secretary of the Treasury to promulgate affiliated corporation regulations with legislative characteristics.

The second change, requiring the Director to only promulgate regulations "not inconsistent" with Chapter 143, appears at first to be nothing more than a codification of the often-cited rule that regulations must be consistent with the statutes to be valid.[112] But we interpret this charge, in this case, as requiring the Director to not violate two consistent themes in its corporation income tax statutes— that the statutory references to "taxable year" be honored and not twisted or ignored, and that federal taxable income for Missouri purposes means what the statutes defines it to mean, without the sort of creative interpretation such as ESI advocates.

The third change, changing "income-tax liability and the various factors necessary for the determination of such liability" to "Missouri taxable income derived from sources within this state," reflects one of the most basic precepts of Missouri income taxation— that only Missouri-sourced income is subject to Missouri income tax.[113] It does not, however, affect this case.

In summary, ESI asks us to interpret 12 CSR 10-2.165(6) as creating a deduction the General Assembly did not create. We will not do that.

---

[112] ***Bridge Data Co. v. Director of Revenue***, 794 S.W.2d 204, 207 (Mo. banc 1990).

[113] Section 143.451.1 RSMo 2013 Supp., *as cited in* ***Jay Wolfe Imports Missouri Inc. v. Director of Revenue***, 282 S.W.3d 839, 840 (Mo. banc 2009).

Our second observation—ESI's argument ignores the statutory emphasis placed on the "taxable year"

Black's Law Dictionary defines "taxable year" as "the period for computing federal or state income tax liability, usually either the calendar year or a fiscal year of 12 months ending on the last day of a month other than September."[114] The United States Supreme Court explained "taxable year" as follows: "'Each 'taxable year' must be treated as a separate unit, and all items of gross income and deduction must be reflected in terms of their posture at the close of such year."[115]

The Missouri corporate income tax structure is based on that concept of the taxable year. Specifically, § 143.431.1 defines "Missouri taxable income" as "so much of its federal taxable income *for the taxable year*, with the modifications specified in subsections 2 to 4 of this section, as is derived from sources within Missouri as provided in section 143.451." Then, § 143.431.3(1) allows affiliated groups filing consolidated federal returns for a taxable year to elect to file a Missouri consolidated return, and provides that "[t]he consolidated taxable income of the electing affiliated group *for the taxable year* shall be its federal taxable income." At the most basic level, ESI's amendment of its federal taxable income as reported on its 2006 federal return violates this statute.

For ESI's argument to work, however, a taxpayer in its position must be able to shift net operating losses incurred by its subsidiaries that filed separate company returns *in prior years* to the taxable year's taxes. As we show above, federal corporate taxpayers are allowed to do that under Treas. Reg. 1.1502.21(a)(2), a regulation promulgated by the Secretary of the Treasury under Congress' grant of the power to promulgate regulations "with the same stature as if

[114] *Black's Law Dictionary* (9th ed.) 1754.
[115] ***United States v. Consolidated Edison Co***., 366 U.S. 380, 384 (1961)

specifically enacted by the Congress."[116] Therefore, not only did the Director not promulgate such a regulation, but the General Assembly did not give him authority to promulgate a regulation that would, in order to work, have to violate Chapter 143's emphasis on "taxable year."

Our third observation—the Supreme Court has, consistently, rejected taxpayers' attempts to adjust federal income tax figures on their Missouri tax returns to fit their theories of taxation

As we illustrate above under "Our approach to this case," ESI simply reduced the amount it showed as taxable income on its federal return by the amount of the deduction it claimed. However, in ***Armco Steel***, ***Mid-America Television v. State Tax Comm'n***, and ***Eilian***, the Supreme Court rejected taxpayers' use of this device to recalculate their taxes in order to fit their respective taxation theories.

As we discuss above under "ESI's first argument," the taxpayer in ***Armco Steel*** invoked § 143.200 as authority for calculating the federal income tax deduction from its Missouri income tax obligation according to what it would have been able to deduct under Treas. Reg. 1.1502-33(d)(2)(i), not what it actually paid as federal income tax.[117] The Court rejected the argument and held that § 143.200 was not to be applied if doing so would change substantive Missouri law.[118]

In ***Mid-America Television Co. v. State Tax Comm'n***,[119] the taxpayers (Mid-America Television Co. and Oliver Advertising, Inc.) were subsidiaries of a parent corporation that filed a federal consolidated return for the tax year (1973), but filed a separate Missouri return for that year. Under § 143.171.1,[120] they were entitled to a deduction for their "income tax liability

[116] ***Robbins Door & Sash Co***., 55 T.C. at 320.
[117] 580 S.W.2d at 245.
[118] *Id*.
[119] 652 S.W.2d 674 (Mo. banc 1983).
[120] RSMo 1978.

under Chapter 1 of the Internal Revenue Code for the same taxable year for which the Missouri return is being filed after reduction for all credits thereon [with certain exceptions not applicable]."[121] On the Missouri return, however, they each claimed a deduction for the amounts that they would have paid in federal income tax, had they filed separate federal returns. The Supreme Court referred to the taxpayers' deduction of this amount as a "hypothetical method" of creating a Missouri deduction, to which they were not entitled.[122]

In ***Eilian v. Director of Revenue***, the taxpayer, an individual, incurred a federal NOL in 2005 of $34,535,832. He carried the loss forward to his 2006 federal return, where his taxable income (before the loss) was $28,418,457, which resulted in a federal taxable income for 2006 of zero.[123]

However, Eilian also had income for 2006 that, while not taxed under federal law, was taxed under Missouri law,[124] and also had deductions for interest income earned on federal obligations that were taxed under federal law but not under Missouri law.[125] The net amount of additional Missouri adjusted gross income from these adjustments was $891,511. He altered his federal adjusted gross income to reduce his Missouri income to zero, in order to apply the additional NOL deduction to which he believed himself entitled.[126]

While this Commission decided Eilian was entitled to make that adjustment, the Supreme Court reversed our decision and held he was not entitled to apply the unused NOL to his 2006 Missouri income tax obligation. The Court cited ***Brown Grp.*** for the rule that:

---

[121] ***Mid-America Television Co***., 652 S.W.2d at 676.

[122] *Id*. at 677.

[123] 402 S.W.3d 566, 569 (Mo. banc 2013).

[124] That income, totaling $893,840, was made up of interest earned from certain non-Missouri state and local obligations. It was to be added to federal adjusted gross income of an individual pursuant to § 143.121.2(3). Just as federal taxable income is the starting point for determining a corporation's Missouri taxable income, an individual's federal adjusted gross income is the starting point for his or her Missouri adjusted gross income. Section 143.121.1.

[125] Those deductions totaled $2,329. They could be deducted from "federal adjusted gross income" pursuant to § 143.121.3(1).

[126] ***Eilian***, 402 S.W.3d at 569-70.

> [A corporate] taxpayer could receive a Missouri tax benefit from a federal NOL if— and only to the extent—that the NOL resulted in a reduction in federal taxable income under I.R.C. § 172 *and* Missouri law plainly authorized the reduction to be reflected in the starting point for the taxpayer's Missouri return.[127]

In all three cases, the taxpayers altered their reported federal income to suit their theories of recovery, but in each case, the Supreme Court rejected both the theories and the means by which they were claimed. Similarly, in this case, ESI altered its federal taxable income, as reported on its federal return, from $481,326,467 to $18,606,843. It is no more entitled to do so than was Armco Steel, Mid-America Television, or Mr. Eilian.

Summary

We deny ESI's motion for summary decision and grant the Director's motion for summary decision.

SO ORDERED on August 5, 2014.

/s/ Mary E. Nelson
MARY E. NELSON
Commissioner

[127] *Id.* at 572.